Supreme Court, U.S.
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No. 93-_____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

C.L. GRIMES and G.W. HOLBROOK, on their own behalf and on behalf of all persons similarly situated,
Petitioners,

v.

VITALINK COMMUNICATIONS CORPORATION, a Corporation; NETWORK SYSTEMS CORPORATION, a Corporation; LESLIE G. DENEND, J. DANIEL MCCRANIE, CHARLES J. ABBE, HARRY T. REIN, and LYLE D. ALTMAN,
Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Third Circuit

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PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

The court below approved a state court's extinguishing a federal cause of action over which Congress denied it any jurisdiction. An academic friend has remarked that he could teach two-thirds of his Federal Courts course from this case, for the opinion below wrongly decided at least seven questions of law, every one of which warrants this Court's attention:

1. Can a state court force upon a person, by the device of a non-opt-out class action under state law, an agent clothed with power to release that person's federal securities law claims, notwithstanding that Congress has expressly deprived state courts of any authority over such claims?

2. At a state court hearing on whether to approve a class action settlement, there is no presentation of evidence or decision on the merits; the court merely generally evaluates, in the light of its business judgment, what the respective sides would give up and receive in the settlement. If at such a hearing a person does no more than argue that the settlement should not be approved because it purports to bargain away substantial claims (including federal claims which were not, and could not have been, presented in the action), has the person thereby "actually litigated" the facts of those claims, so as to be foreclosed by issue preclusion from presenting them in a subsequent federal action?

3. Over and above these two key issues, did the court below err in holding:—

(a) That if a nonresident stockholder in a Delaware corporation sells his stock, in New York, to a third party in response to a tender offer, that is a sufficient "minimum contact" with Delaware to support personal jurisdiction, at least if there is pending some Delaware state lawsuit,

related to the tender offer, in which a class including the stockholder might be certified?

(b) That a state can empower the representative plaintiff in a non-opt-out equitable class action to give a release, binding on all class members, of damage claims at law?

(c) That a state can empower the representative plaintiff in a non-opt-out class action to give a release, binding on all class members, of claims based on a different set of facts from those on which the class action is based?

(d) That a class member who does not appear in a class action is precluded from any subsequent collateral attack on the judgment in the action?

(e) That a class member who objected to a class action settlement is precluded from thereafter contending that the court's response to his objection was constitutionally inadequate?

PARTIES TO THE PROCEEDING

The names of all parties appear in the caption of the case.

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On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Third Circuit

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PETITION FOR A WRIT OF CERTIORARI

C.L. Grimes and G.W. Holbrook respectfully petition the Court for a writ of certiorari to review the judgment of the United States Court of Appeals for the Third Circuit in this proceeding.

I. JURISDICTION

The opinion below, 17 F.3d 1553, reprinted at pp. 1a-41a of the Appendix ("App."), affirmed a judgment of the

District Court for the Eastern District of Pennsylvania (opinion reported only in computer services; reprinted at App. 42a). The opinion below was issued on March 9, 1994. Petitioners, plaintiffs below, timely petitioned for rehearing and suggested rehearing in banc, denied April 6, 1994. App. 86a. This Court has jurisdiction to review the judgment by certiorari under 28 U.S.C. § 1254(1).

The case involves the Supremacy Clause, the Due Process Clauses of the Fifth and Fourteenth Amendments, the Full Faith and Credit Act, 28 U.S.C. § 1738, and Rule 23 of the Rules of the Court of Chancery of Delaware. These are reproduced at App. 94a.

II. STATEMENT OF THE CASE

In summary: This is a federal securities action arising from a tender offer. The petitioners, plaintiffs below, had been included by a state court in a non-opt-out class action involving a different claim relating to the tender offer, arising under state law. The "representative" plaintiff in that case had settled and given a broad general release of all claims related to the tender offer. The court below held that that release precludes this action, even though Congress has denied the state courts any jurisdiction over federal securities claims; and held that petitioners are precluded from questioning the state court settlement in this proceeding.

Petitioners Holbrook and Grimes live in Connecticut and Pennsylvania respectively. Respondent Vitalink was a California-based business incorporated in Delaware. Respondent Network Systems Corporation ("NSC") is a Minnesota-based business incorporated in Delaware. The individual respondents were officials of Vitalink and NSC.

Holbrook and Grimes were substantial Vitalink stockholders, with holdings of over $2,000,000 even at the $10.50 price described *infra*. In May 1991, management of Vitalink and NSC agreed on an arrangement for Vi-

talink to become a wholly-owned subsidiary of NSC, and on May 7, 1991, NSC announced a tender offer for Vitalink stock at $10.50 a share. Holbrook tendered his shares; Grimes did not.

When the tender offer successfully closed on June 20, NSC bought the tendered shares (including Holbrook's) and became a 90% owner of Vitalink. By letter of July 11, the non-tendering stockholders (including Grimes) were notified that they had been "squeezed out" under Delaware law on July 1, *i.e.*, their shares had been transformed into rights to receive $10.50 per share or to seek appraisal, and NSC had become the 100% owner.

It transpired that important information on the stock's value had been withheld. Grimes and Holbrook accordingly brought this action for damages against Vitalink, NSC, and various officials of the companies for violations of §§ 10(b) and 14(e) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j and 78n(e), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5. Jurisdiction in the court of first instance was based on 15 U.S.C. § 78aa and 28 U.S.C. § 1331. Federal jurisdiction is exclusive. 15 U.S.C. § 78aa.

The district court dismissed on the ground of a release signed by three lawyers, strangers to Holbrook and Grimes whom they had never authorized to release their claims.

That came about thus. As soon as the proposal was announced the plaintiffs' class action bar had raced to the courthouse. Within a few days, seven similar complaints had been filed, four as class actions in the Court of Chancery of Delaware under Rule 23 of its rules (substantially identical to FED. R. CIV. P. Rule 23, App. 95a), and three in California state courts. The earliest complaint, *John P. McCarthy Profit Sharing Plan* v. *Vitalink Communications Corp.*, was representative and was designated as the con-

solidated complaint.[1] It charged (on what basis is unclear) that respondent Denend (Vitalink's CEO) and others of Vitalink's management, by the offer of lucrative jobs with NSC, had been induced to sell out to NSC without taking steps to maximize Vitalink's value in the marketplace; thus breaching their fiduciary duties of loyalty and care. App. 101a-105a. It was a purely equitable action for a declaration and an injunction or rescission, with unspecified damages mentioned only in passing. App. 105a.

The Delaware complaint and the complaint in this case are reprinted at App. 99a and 107a; their key portions are laid side by side in Table 1, App. 122a. The Delaware action was based exclusively on management's alleged putting of their own interests first. *It was not an action for breach of any duty of disclosure and made no allegation of that kind.* Aside from the basic story of the tender offer itself, *the Delaware action had little or no factual overlap with a disclosure case such as the present one.* See Table 1, App. 122a.

Barely three weeks later, the lawyers for the Delaware plaintiffs had already struck a deal. Vitalink and NSC agreed to trivial changes in the tender offer, and agreed not to oppose a generous fee ($275,000, or over $500 an hour) to the plaintiffs' lawyers, to be paid by Vitalink. In exchange, the plaintiffs' lawyers agreed to a release of *all* claims arising out of the tender offer, broad enough to (purportedly) include federal claims. App. 92a-93a.

The deal was signed as of June 10. Not till July 16, after the acquisition and "squeezeout" were consummated, was it presented to the Court of Chancery for approval. That court certified on July 18 a *non-opt-out* class of stockholders (including Grimes and Holbrook). It did so without finding that the "representative" plaintiffs fairly repre-

[1] The other suits added nothing and the California cases remained dormant until released in the settlement; so, like the state courts and the courts below, we will deal only with the *McCarthy* complaint.

sented the class, and to this day nobody but the "representative" plaintiffs and their lawyers knows how much stock they had and whether they had a more than trivial interest in the matter. (The Supreme Court of Delaware has since decreed that such a finding must be made in all class action settlements. *Prezant* v. *DeAngelis,* 636 A.2d 915 (Del. 1994)). On July 29 the court sent out a notice of settlement hearing.

Holbrook did not appear at the settlement hearing. Grimes did, and objected to the settlement as a sham on two grounds. *First,* he challenged its adequacy. In return for only cosmetic changes, the sweeping release would purportedly give up all claims—including the disclosure claims here involved, which had been neither advanced nor explored by the "representative" plaintiffs' lawyers. *Second,* he contended that the "representative" plaintiffs had not adequately represented the class, and that accordingly a record sufficient to evaluate the settlement had not been developed. He pointed to the small amount of discovery taken, the lack of any expert review of the company's investment bankers' work, the non-adversary tenor of key depositions, and a "runaround" in efforts to get information as to the *bona fides* of the lawsuit and the settlement negotiations.

Grimes had no opportunity to contest the certification of a non-opt-out class. That was a *fait accompli.*

The settlement hearing was held on written submissions and oral argument, without formal evidence or testimony. This is normal Delaware practice. *The court does not decide the merits of the case or of any other claim that may be discussed in evaluating the settlement;* rather, it generally evaluates the claims and their likelihood of success, and balances, based on its business judgment, its appraisal of what is being received against its appraisal of what is being given up. *E.g., Barkan* v. *Amsted Industries, Inc.,* 567 A.2d 1279 (Del. Super. 1989); *Rome* v. *Archer,* 564

A.2d 1089 (Del. Super. 1989); *Polk* v. *Good*, 507 A.2d 531 (Del. Super. 1964).

On November 8, the court approved the settlement, *In re Vitalink Communications Corporation Shareholders Litigation*, [1991-92 Transfer Binder] FED. SEC. L.REP. (CCH) ¶ 96,585, App. 53a—even though it found the "benefits" conferred on the stockholders to be of merely "speculative" value, App. 82a; found it "troubling" that the "representative" plaintiffs had misrepresented the record, App. 64a n.1; and found that a "cloud of doubt" which the Vitalink board should have "*fully* accounted for" (emphasis original) remained on Vitalink's investment banker's valuation analysis. App. 69a-70a. The court discussed three specific failures to disclose that Grimes had pointed to, and appraised them as not material. App. 76a-80a. It summed up by saying that "[a]s far as the claims that could be asserted" but were not (such as disclosure claims), "there is no indication of their merit," App. 82a, and that "due care and candor claims carry very little chance of success at trial." App. 85a. As for the duty of loyalty and care claims *actually* asserted by the "representative plaintiffs", it concluded that they were "very weak." App. 82a. The court did not even discuss Grimes's contention that the class had not been fairly represented. It did hold that the record was "sufficiently developed" to provide "an adequate basis upon which . . . to determine whether the Settlement Agreement was fair . . . ." *Ibid.* It accordingly approved the settlement. The Supreme Court of Delaware affirmed *per curiam*. 610 A.2d 725 (1992).

The Court of Chancery ignored a constellation of suspicious circumstances pointing to a sham settlement, including settlement before class certification, attorneys' fees to be paid by defendants with a "clear sailing" agreement, an extraordinarily high fee, no evidence to justify its amount, evasiveness about the deal, minimal discovery, speculative benefits, and a sweeping release. Grimes accordingly petitioned this Court for certiorari on the ques-

tion of what minimum procedural requirements due process obliges a state court to observe in reviewing a class action settlement as to fair representation. This Court denied certiorari. *Grimes* v. *John P. McCarthy Profit Sharing Plan*, 113 Sup. Ct. 179 (1992).

Meanwhile, Grimes and Holbrook had filed the instant action. The cause of action asserted (inadequate disclosure under federal law in the sale of their stock by the stockholders to an outside party; no fiduciary duty claims) has next to nothing in common with the cause of action asserted in the state case (breach of directors' state law fiduciary duty of due care and loyalty to the stockholders; no disclosure claims) and next to no issues of fact in common with it. Once again, see Table 1, App. 122a. Moreover, unlike the state *equity* case, this action is at *law* for very substantial *money damages* with a jury. The district court held that the release in the Delaware settlement barred the action. The court below affirmed.

The reasoning below is not easy to follow and, with respect, the opinion is replete with misapprehensions of fact. We believe the following is a fair summary.

To begin with, the opinion never directly addresses the key question of where a state court could purport to get the power to force upon Grimes and Holbrook an agent authorized by it to release claims over which Congress had denied it all jurisdiction. It approaches the matter, not from the crucial viewpoint of the court's *subject-matter* jurisdiction, but rather from the irrelevant viewpoint of the state court's *personal* jurisdiction over Grimes and Holbrook. It held that the Delaware court had personal jurisdiction over Grimes because he "appeared at the settlement hearing to litigate [*sic*] his objections." App. 11a n.5. It held that the Delaware court had personal jurisdiction over Holbrook on the ground that his owning stock in a Delaware corporation and tendering his shares supposedly "with knowledge of his status as a member of

the plaintiff class in a pending class action lawsuit" containing appropriate procedural protections gave him sufficient "minimum contacts" with Delaware. App. 13a. It held that because the state court thus had personal jurisdiction over Grimes and Holbrook, the principle of *Phillips Petroleum Co.* v. *Shutts*, 472 U.S. 797 (1975), did not require opt-out in the state court proceeding. App. 14a-16a.

It then concluded that the release in the state equity suit, and Grimes's participation in the settlement hearing, preclude this federal damages action at law under the Full Faith and Credit Act, 28 U.S.C. § 1738, as interpreted in *Marrese* v. *American Academy of Orthopaedic Surgeons*, 470 U.S. 373 (1985), because "a state court would conclude that the plaintiffs are collaterally estopped from relitigating [*sic*] the factual issues of nondisclosure, adequacy of representation, and fairness of the settlement . . . ." App. 20a. Underlying this proposition was the mistaken concept that all these issues had indeed been actually "litigated" in the state court by Holbrook (who never appeared there) and by Grimes. App. 17a-19a.

The majority opinion thus stands for at least the following propositions of law (among others):

Proposition 1. A state court can force upon a person, by the device of a non-opt-out class action, an agent clothed with power to release that person's federal securities law claims, notwithstanding that Congress has expressly deprived state courts of any authority over such claims.

Proposition 2. For a class member merely to appear at a settlement hearing and argue that the settlement should not be approved because it purports to bargain away substantial federal disclosure claims which were not (and could not have been) presented in the state class action, constitutes "actual litigation" of the facts of those claims, resulting in issue preclusion in a subsequent federal action—even though at the hearing evidence is not presented, the merits are not decided, and the court merely

generally evaluates the claims within the context of an overall appraisal of the settlement in the light of its business judgment.

Proposition 3. If a nonresident stockholder in a Delaware corporation tenders his stock (outside Delaware) to a third party in response to a tender offer, that is a sufficient "minimum contact" with Delaware to support personal jurisdiction, at least if there is pending some Delaware state lawsuit related to the tender offer transaction in which a class including the stockholder might be certified.

Proposition 4. A state can empower the representative plaintiff in a non-opt-out equitable class action to give a release, binding on all class members, of damage claims at law.

Proposition 5. A state can empower the representative plaintiff in a non-opt-out class action to give a release, binding on all class members, of claims based on a different set of facts from those on which the class action is based.

Proposition 6. A class member who does not appear in a class action is precluded from any subsequent collateral attack on the judgment in the action.

Proposition 7. A class member who objected to a class action settlement is precluded from thereafter contending that the court's response to his objection was constitutionally inadequate.

III. REASONS FOR ALLOWANCE OF THE WRIT

A. The Decision Below Gives Approval to the Key Element of a Major Abuse of Class Action Procedure

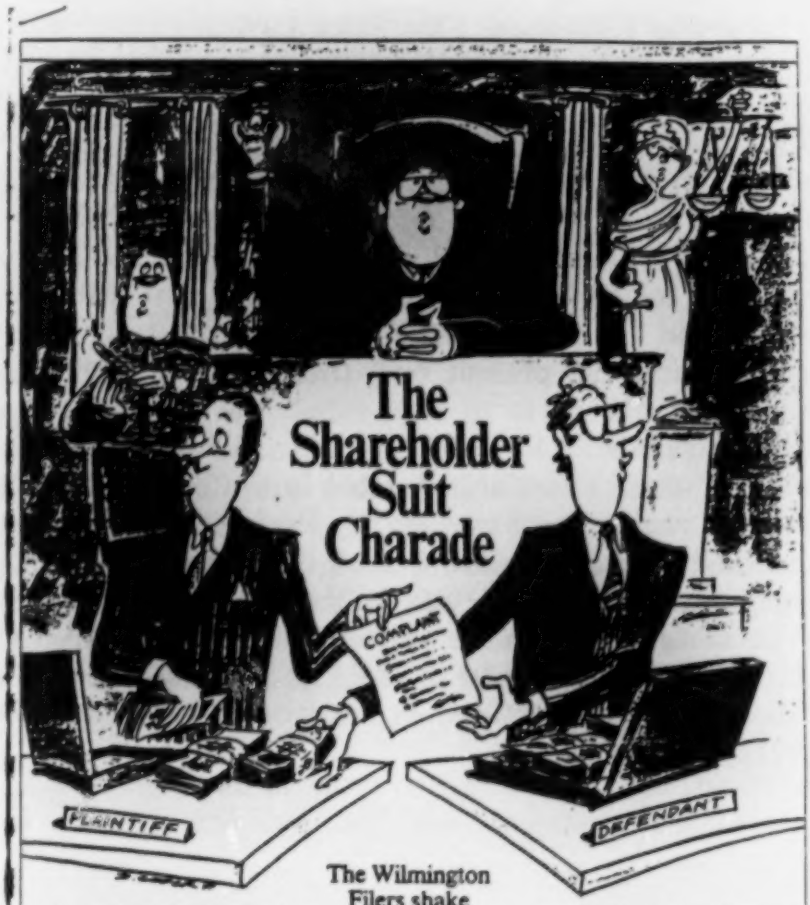
This past January 26, the Chairman of the SEC voiced "concerns about private securities litigation and the role it plays in the vital process of capital formation." *Remarks*

by Chairman, Arthur Leavitt . . . Securities Regulation Institute, U. of Calif. San Diego, January 26, 1994, at 2. Among "indications that our current system is flawed," he mentioned that "virtually all securities class actions are settled for some fraction of the claimed damages, and some allege that settlements often fail to reflect the underlying merits of the cases." *Id.* at 3. He criticized law firms' "maintaining an inventory of shareholders to serve as nominal plaintiffs in class action filings," and expressed his "especial[] interest[] in ways to give shareholders greater control over their own litigation and curb potential conflicts of interest between class action lawyers and the shareholders they represent." *Id.* at 6.

A major target of these strictures is the "Delaware settlement," which has become, like the "Nevada divorce," a classic abuse that brings scorn on the legal system. Holding in readiness a stable of clients who own stock—often, it seems, in only trivial amounts—in nearly every publicly traded company, a relatively small number of lawyers scrutinize the business news, and immediately upon sighting a transaction that *might* be vulnerable to a claim of breach of duty by a company's directors, file a non-opt-out class action in equity against the company in state court under state law. After minimal discovery, the claim is settled for a cosmetic consideration and a large attorney's fee. The lawyer—theoretically, of course, the "class representative"—gives in return a general release that purports to cover all claims arising out of the transaction. The state court approves the settlement. The only winners, of course, are the lawyers and the defendant companies, who are happy to pay the lawyers generously for such a "plenary indulgence" or "vaccination." Substantial stockholders with genuine claims are frozen out.

The legal trade press has long regarded the "Delaware settlement" as, quite simply, a scandal. We respectfully refer the Court in particular to *The Shareholder Suit Charade: The Wilmington Filers shake down corporations in*

Delaware, and no one seems to mind, AMERICAN LAWYER (Dec. 1989) 67. Rather than quote from the text, we ask the Court's indulgence for our reproducing its first page, on the theory that quoting one picture is worth quoting a thousand words.



The Wilmington Filers shake down corporations in Delaware, and no one seems to mind.

By Anthony Borden

At an August settlement hearing in Delaware's court of chancery Steven Schulman, an associate at New York's premier shareholders firm, 72-lawyer Milberg Weiss Bershad Specthrie & Lerach, tried to explain exactly what his suit against Champion Spark Plug Company and its two bidders had accomplished. What "consideration" had the plaintiffs won in return for releasing their accusations? Why should the plaintiffs' counsel get paid?

It wasn't easy.

"This was not a lay-down litigation," argued Schulman, 38. "If we had filed a boilerplate complaint and sat on this case on day one . . . I would say to Your Honor I would have a problem coming here be-

Legal scholars have likewise expressed dismay over the phenomenon. "Much like the production of sausage and legislation," Professor John C. Coffee, Jr., of Columbia Law School has written, "the settlement of securities litigation is a process that the high-minded are best advised not to examine too closely." Coffee, *Suspect Settlements in Securities Litigation*, NEW YORK LAW JOURNAL, March 28, 1991, p. 5 col. 1. At least two major studies corroborate what Professor Coffee described as the long-available anecdotal evidence that "the result can be collusive settlements in which low recoveries are exchanged for high plaintiffs' attorneys fees." *Ibid.* In one, Professor Roberta Romano of Yale studied 83 settlements of stockholder actions and confirmed, among other things, that attorneys' fees loomed far larger than plaintiffs' recoveries. In settlements (like the present one) that afforded only structural relief, the value of such relief, she concluded, was "inconsequential." Romano, *The Shareholder Suit: Litigation Without Foundation?*, cited in Coffee, *Suspect Settlements, supra.* Another study, by Professor Janet Cooper Alexander of Stanford Law School, demonstrated that "the strength of the plaintiffs' case on the merits did not appear to be a significant factor in determining the outcome." Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STANFORD L. REV. 497, 500 (1991).[2]

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[2] See also, *e.g.*, Coffee, *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 714-20 (1986); Coffee, *The Unfaithful Champion: The Plaintiff As Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. (Summer 1985) 5, 26-33; Coffee, *Rescuing the Private Attorney General: Why the Model*

More recently, the matter has boiled over into the general press. *"Millions for Us, Pennies for You,"* trumpeted a headline in the *New York Times* a few months ago, with the subhead: *"Suits on behalf of investors enrich lawyers. But what of their clients?"* NEW YORK TIMES, December 19, 1993, Section 3, p. 1. ("[T]he law firms representing these investors can win approval for settlements of a few cents on the dollar for their clients while pocketing millions of dollars—even tens of millions—for themselves. . . . 'The only people who make money in these are the claimants' lawyers, and the defendants themselves, who shut off a lot of potential liability.' . . . 'The lawyers' interest shifts from protecting the investor to protecting the deal.' ") See also Moses, *Off to Court: Lawyer Given To Filing Shareholder Lawsuits Comes Under Scrutiny,* WALL ST. JOURNAL, October 28, 1992, p. 1, col. 8.

Earlier last year, the practice of maintaining a stable of stockholders from which plaintiffs could be "pressed into service at the drop of certain stock prices" received general publicity as a result of *Greenfield* v. *U.S. Healthcare, Inc.*, 146 F.R.D. 118 (E.D. Pa. 1993). See, *e.g.*, Moses, *Three Shareholder Lawyers Sanctioned,* WALL ST. JOURNAL, February 5, 1993, p. B7, col. 1.

According to an industry newsletter, in 1993 the eleven law firms involved in the greatest number of

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of the Lawyer as Bounty Hunter Is Not Working, 42 MD. L. REV. 215, 232-33, 239-40 (1983). See also *Private Litigation Under the Federal Securities Laws: Hearings Before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs,* S. HRG. 103-431, 103D CONG., 1ST SESS. 44-46, 117, 305-307, 416-417, 458, 461-62, 602 (1993).

settlements of stockholder class-action lawsuits were in an average of 18.5 such settlements each, or one every three weeks. The top firm was involved in 40 such settlements, and the runner-up in 26. Bowers & Gupta, *Shareholder Suits Beset More Small Companies,* WALL ST. JOURNAL, March 9, 1994, p. B1, col. 5.

Adverse public attention to class action settlements is not, of course, restricted to securities cases. See, *e.g.,* a lead editorial headed *"Coupon Clipping for Lawyers"* in the WALL STREET JOURNAL, November 18, 1993, p. A20, col. 1. ("[W]e have a hard time believing the lawyers deserve their money for producing a settlement in which all the real money goes to the lawyers. . . . Funny, we thought the justice system was supposed to have something to do with, well, justice.") See also Baron, *An Asbestos Settlement With a Hidden Agenda,* WALL ST. JOURNAL, May 6, 1993, p. A11, col. 3; Burton, *The Litigator: How Stanley Chesley Settles Things Quickly in Mass-Injury Suits: Class-Action Attorney Earns Big Fees in Settlements Some Say Are Premature,* WALL ST. JOURNAL, June 26, 1992, p. 1, col. 1.

The key element of the Delaware settlement industry is the ability of the purported class representative to release *all* claims, *including federal ones.* Otherwise the indulgence is not plenary; and if it is not plenary it will not command much of a price. Professor Coffee eloquently summarized the implications of this at the time of the first federal case to bless it, Judge Selya's opinion in *Nottingham Partners* v. *Trans-Lux Corp.,* 925 F.2d 29 (1st Cir. 1991):

> "[F]or the litigator, the most interesting recent development in securities litigation may be the appear-

ance of *a new technique by which a collusive settlement—that is, a non-adversarial settlement that maximizes the attorney's interest at the expense of the client's*—can be negotiated. . . . .

"Because the general release issued to the defendants in the state court settlement resulted in issue preclusion, the consequence was that no court, state or federal, could hear plaintiffs' claim of proxy fraud. The seeming paradox in *Nottingham Partners* is that a state court settlement can have preclusive effect despite the fact that the state court lacked subject matter jurisdiction over the claims thereby barred.

"While the legal issue of when one court has the power to approve the release of claims pending in another forum is complex, the practical message to plaintiffs' counsel is much simpler: *weak derivative and class action claims that once would have been routinely dismissed by the Delaware Chancery Court now have an enhanced settlement value, because they can confer immunity with respect to . . . federal securities class actions, which often would have a significant settlement value.*

"Ironically, the incentives for defendants are even clearer: never seek dismissal on the merits of a state class action if a companion federal class action raising related federal claims is possible, but instead reach a settlement in which the defendants are given a general release. If properly structured to fall within the *Nottingham Partners* precedent, such a release will preclude a federal class action raising federal securities claims.

"This type of settlement can be described as 'collusive' because the parties to the state court settlement are effectively depriving absent players—the plaintiffs and their attorneys in the federal action—

> of their day in court. The net result is effectively both a wealth transfer from the federal plaintiffs' attorneys to the state plaintiffs' attorneys and *a reduction in the total recovery to the class (because the state plaintiffs' attorneys are settling federal claims that they can never win, but can only settle, and should thus accept a lesser settlement than would the federal plaintiffs' attorneys*).
>
> "Although it is still premature to predict that Rule 10b-5 actions will become an endangered species, the possible end result of *Nottingham Partners* will be that the already well-traveled road to the Delaware courts could become a six-lane highway as plaintiffs and defendants rush to settle there before a federal court can stay them."

After pointing out that in the companion state case the Delaware Supreme Court had held that a non-opt-out class was permissible when the action primarily sought equitable relief, Professor Coffee observed:

> ". . .Delaware's approach poses a major hurdle for securities plaintiffs because it is easily manipulated.
>
> . . . .
>
> ". . . [E]ven plaintiffs who have filed an earlier action for monetary damages in federal court are in trouble, because a Delaware action can always be brought for injunctive relief and will predictably settle quickly in order to be used as a barrier to the federal action."

Coffee, *Suspect Settlements in Securities Litigation, supra* (emphasis added). Stated differently, the weaker, less developed, and more feebly pursued the state claim, the easier it will be to persuade the state judge to accede to a settlement and hence the easier it will be to use it to dispose of a federal claim.

It is the key element of such "collusion" and "manipulation" that is blessed by the decision below.

B. The Decision Below Is Replete With Errors of Law Which Involve Questions Which Have Not Been, But Should Be, Settled by This Court, And As to Several of Which There Are Conflicting Decisions in Other Circuits

We turn now to the propositions of law for which the decision below stands.

1. The Question of a State Court's Ability To Authorize Extinction of a Federal Claim Over Which It Has No Jurisdiction

Proposition 1, *supra,* is far and away the most important aspect of the case. It is wrong because of the Supremacy Clause. When Congress has conferred on Grimes and Holbrook a right under the federal securities laws, which Congress has said cannot be adjudicated in a state court, but only in a federal court before an Article III judge under federal procedure (including federal class action procedure) and with a Seventh Amendment jury, a Delaware chancery court has no power to take that right away from them through a non-opt-out class action or any other device.

It is perfectly true that "a state court has the power to enter a settlement negotiated *by the parties* as a judgment which releases exclusive federal claims that the state court could not itself entertain." App. 21a (emphasis added); see also App. 2a. But the key is "*by the parties.*" If Holbrook and Grimes or agents empowered by them had "negotiated" this release, of course it would bind them. But the release was agreed to not by them but by agents forced on them. As Judge Friendly pointed out in his characteristically perceptive analysis in *National Super Spuds, Inc.* v. *New York Mercantile Exchange,* 660 F.2d 9, 18-19 (2d Cir. 1980), the designation of a class repre-

sentative is simply the judicial appointment of an agent and the clothing of that agent with defined and limited powers. In the *opt-out* situation each of the individual class members in effect ratifies or repudiates the appointment. But when a court designates a *non-opt-out* class, it is compelling the class members to accept willy-nilly an agent clothed with whatever powers the court may confer on him.

So, when here the Delaware court certified strangers to Holbrook and Grimes as "representatives" of a non-opt-out class, it was purporting to constitute these strangers as their agents under its rules. Can Delaware assume the power to authorize it to apply those rules to *federal* claims over which the State has no authority? We believe that it cannot, under the Supremacy Clause.

A state court cannot do anything that interferes with a right of action in federal court, for "[t]he right to pursue federal remedies and take advantage of federal procedures and defenses in federal actions may [not] . . . be restricted by a state court . . . ." *General Atomic Co.* v. *Felder,* 434 U.S. 12, 18-19 (1977). The right of a federal-court litigant to pursue his right to federal-court remedies "was granted by Congress and cannot be taken away by the State." *Donovan* v. *Dallas,* 377 U.S. 408, 413-14 (1964).

Nor can a state's procedural rules—such as its class action rules—be allowed to impair a federal right. "The laws of the United States cannot be evaded by the forms of local practice." *American Railway Express Co.* v. *Levee,* 263 U.S. 19, 21 (1923) (Holmes, J.). "The States cannot, in the exercise of control over local laws and practice, vest State courts with power to violate the supreme law of the land." *Kalb* v. *Feuerstein,* 308 U.S. 433, 439 (1940).

A state can no more dispose of a person's federal claim over which it has no jurisdiction than it could interfere with any other property grant by the United States. "[A] chose in action is a constitutionally recognized property

interest . . . ." *Phillips Petroleum Co.* v. *Shutts,* 472 U.S. 797, 807 (1985). A damages claim under the federal securities laws is thus as much a property right conferred by the United States as is a grant of real property by the United States. And "[m]anifestly Congress is vested with the absolute right to designate the person to whom real property belonging to the United States shall be transferred, and to prescribe the conditions and mode of the transfer; and a state has no power to interfere with that right or to embarrass the exercise of it." *United States* v. *Board of Commissioners of Fremont County,* 145 F.2d 329, 330 (10th Cir. 1944), *cert. denied,* 323 U.S. 804 (1945).

The state of Delaware obviously could not itself assume the right to dispose of the class members' federal claims; and it cannot confer on a private individual (here, the purported class representative) the legally enforceable authority to do what it cannot do itself.

The situation is closely analogous to *Phillips Petroleum Co.* v. *Shutts, supra,* holding that where a plaintiff class member is outside the court's personal jurisdiction, due process will not permit the court to force upon him an agent empowered to deal with his claim. Identical considerations apply here, except that here the forum state's inability to force an agent upon the absent class members reflects not merely that they are out of its physical reach, but that the subject-matter of the purported agency is out of reach of the forum state's courts; and except that the governing constitutional provisions are the Supremacy Clause and basic notions of federalism.

The court of appeals decision that offers nearest support for the decision below is Judge Selya's opinion in *Notthingham Partners* v. *Trans-Lux Corp.,* 925 F.2d 29 (1st Cir. 1991) (discussed by Professor Coffee in the article excerpted *supra*). *Nottingham* in turn relied on language in *Abramson* v. *Pennwood Investment Corp.,* 392 F.2d 759, 762 (2d Cir. 1968), in which a general release in settlement

of a state court derivative action was held to bar a parallel federal securities action. But—as Judge Hutchinson pointed out in his dissent below, App. 39a n.11—*Abramson* was a *derivative* action, not a *representative* one. In a derivative action a stockholder sues to vindicate the corporation's claims, not his own. He brings the corporation itself before the court *as a party* and causes it to take action to protect its interests. In a representative action, by contrast, the plaintiff is asserting his own claims and those of non-parties with similar rights who are not before the court. Settlements in the two types of cases are thus completely different. In a derivative suit, as Judge Friendly pointed out in *National Super Spuds, supra,* "the legal entity whose unpleaded claims are being released—the corporation—is a party to the settlement. The corporation has the power to release its claims whether asserted in the complaint or not," 660 F.2d at 18-19, whereas in a representative suit there is no one with power to give a release of the class's rights in addition to the judgment. *Id.* at 18. *Abramson,* in other words, sheds no light on the effect of settlements negotiated by persons *other than the parties.* A party can obviously always release his own claim. This truism tells nothing about authority to release someone else's.

No other circuit opinion besides *Nottingham* has directly addressed the question. Several have considered the authority of a class representative in a *federal* action to release a *state* claim. Because of pendent jurisdiction, this is fundamentally different from the authority of a *state* court to deal with a *federal* claim *over which Congress has denied it jurisdiction,* although some of these opinions contain loose language which out of context might be claimed to support the decision below. (And some involve opt-out considerations; *cf.* the dissent below, App. 39a n.11.) *Class Plaintiffs* v. *City of Seattle,* 955 F.2d 1268, 1287-89 (9th Cir.), *cert. denied,* 121 L.Ed.2d 333 (1992); *TBK Partners, Inc.* v. *Western Union Corp.,* 675 F.2d 456 (2d Cir. 1982);

In Re Corrugated Container Antitrust Litigation, 643 F.2d 195 (5th Cir. 1981), *cert. denied*, 456 U.S. 998 (1982); *cf. In Re Real Estate Title and Settlement Services Litigation*, 869 F.2d 760 (3d Cir.), *cert. denied*, 493 U.S. 821 (1989). *In Re General Motors Corp. Engine Interchange Litigation*, 594 F.2d 1106 (7th Cir.), *cert. denied*, 444 U.S. 870 (1979), seems clearly contrary to *Nottingham* and the opinion below, saying that when a district court had declined to exercise pendent jurisdiction over state claims, it "was without power to extinguish them" in approving a settlement. 594 F.2d at 1134. The Seventh Circuit would doubtless *a fortiori* hold that a state court was without power to extinguish exclusively federal claims.

The operative factor, moreover, is the limit placed by Congress on the state court's *subject-matter* jurisdiction. The question has nothing to do with due process limits on *personal* jurisdiction. *It would make no difference if Grimes and Holbrook lived in downtown Wilmington; the Delaware court could still not authorize anyone to give away their federal rights.*

2. The Question Whether Mere Evaluation of a Possible Claim at a Settlement Hearing Can Constitutionally Be Deemed "Actual Litigation" of the Facts of the Claim, Resulting in Issue Preclusion

Proposition 2. The opinion below tries an end-run around the problem by treating it as one of personal jurisdiction and issue preclusion. It reasons that the state court had personal jurisdiction over Holbrook and Grimes; it could therefore force them into a non-opt-out class with respect to the state proceeding; Delaware courts would then regard them as precluded from litigating elsewhere any issue supposedly "litigated" in the settlement hearing, and under the Full Faith and Credit Act, 28 U.S.C. § 1738 (federal courts must give the same effect to state court judgments as the state court would), as refined in *Marrese*

v. *American Academy of Orthopaedic Surgeons,* 470 U.S. 373 (1985), they were likewise so precluded in this case.

The plain error in this argument is that the Full Faith and Credit Act itself necessarily incorporates constitutional due process limitations on the preclusive effect a state court can give to a judgment. *Kremer* v. *Chemical Construction Corp.,* 456 U.S. 461, 482-83 (1982). And Delaware could not constitutionally preclude any issues in a disclosure case as having been "litigated" based on what transpired at the settlement hearing. (Nor in fact would Delaware do so; we believe that the court below, with respect, distorted Delaware preclusion law to reach its decision here.) For a person to be deprived of a claim on the ground of issue preclusion, due process demands that the issue have been *actually litigated* and *actually decided,* and have been *necessary* to the decision. RESTATEMENT, JUDGMENTS 2D § 27.

"Actually litigated" in this context means that the issue is "properly raised, by the pleadings or otherwise, and is submitted for determination, and is actually determined." RESTATEMENT, JUDGMENTS 2D § 27 Comment *d.* Moreover, due process demands full opportunity to present evidence and rebut opposing evidence with respect to the issue sought to be precluded. *Kremer, supra,* at 483-84. Nothing of the sort happened or could have happened in the settlement hearings. Disclosure claims came up solely in the context that Grimes argued that they existed and were too valuable to be given up for a derisory consideration. The issues underlying the present claim are such matters as whether material information was withheld, *scienter,* and the like. *Nothing* of this kind was either "submitted for determination" or "actually determined" at the settlement hearing. At such a hearing—

> "[t]he court is concerned only with the *likelihood* of success or failure; the actual merits of the controversy are not to be determined. The evidence is limited

> accordingly. The rules of evidence are relaxed. The court listens to the advice and wishes of interested parties. This is not the procedural stuff from which binding determinations of fact can be drawn."

Haudek, *The Settlement and Dismissal of Stockholders' Actions*, 23 Sw. L.J. 765, 809 (1969) (emphasis original) (footnotes omitted). The full description of the proceedings at App. 54a, 59a-85a, confirms that the settlement hearing here was of this nature. The state court was explicit that "*it is not necessary for the Court to decide the merits of the case.*" App. 60a (emphasis added). Moreover, since the "predicate facts" in the two cases have little or no overlap other than the general background of the tender offer, Table 1, App. 122a, even if the state case had been in truth "litigated," the disclosure issues relevant here would have been unnecessary to a decision and neither tried nor decided.

With respect, it is truly astonishing that the court below could have considered that by objecting at the settlement hearing Grimes "actually litigated" state law "disclosure claims" whose "predicate facts" "overlap significantly" with the "predicate facts" underlying this federal securities law claim. App. 7a. For it to say that the state courts "rejected Mr. Grimes' disclosure claims," App. 10a; that "Grimes pursue[d] the . . . disclosure claims through the Delaware court system," App. 10a; that "the facts that underlie the federal non-disclosure claims were *actually litigated* during the state court proceeding and were *conclusively resolved* against the objectors," App. 17a (emphasis added), and similar statements, is simply inexplicable.

Due process will not permit Grimes to be deprived of a substantial claim by characterizing the settlement hearing's general discussion and overall appraisal as "actual litigation" by him of the "underlying facts."

3. Other Class Action Questions, Including Personal Jurisdiction, Scope of Representation, Collateral Attack, and Minimum Standards for Settlement Approval

Proposition 3. The discussion of Proposition 2 applies only to Grimes, for Holbrook never appeared at the hearing and can have "litigated" nothing. The court below held *him* bound by the release on the ground that he had "minimum contacts" with Delaware. "An appropriate basis for the Delaware court's power to bind non-resident shareholders in such a proceeding," it said (without authority, analysis, or explanation), "is ownership of Vitalink stock together with any other activity engaged in by the members of the class pursuant to their shareholder rights." App. 12a-13a. This is inconsistent with *Shaffer* v. *Heitner*, 433 U.S. 186 (1977), holding that even being a stockholder *and an active officer or director* in a Delaware corporation is not a "minimum contact." Moreover, the opinion's gropings for some such "any other activity" are, with respect, unintelligible. Without going into the tangled detail, we note that Holbrook tendered his stock (in New York, *not* in Delaware) *before* the tender offer closed on June 20 and hence his tender could not have been in response to either the July 11 letter or the July 29 notice (at different places the opinion below says both: App. 5a, 13a, 15a). The opinion thrice refers, without elucidation, to tender of shares "*to* the Delaware corporation." App. 2a (emphasis added), App. 13a, App. 14a n.7. It twice says Holbrook tendered in response to "the proxy mailing" or "a proxy offer," App. 2a, 16a, yet *there was no proxy involved anywhere in the transaction.* In any case, how can the sale of stock in New York, whether or not with knowledge of a pending class action settlement, constitute "purposeful availment" of any privilege or protection of Delaware law? See Judge Hutchinson's dissent below, App. 26a-27a.

The opinion on this point is fraught with mischief as a precedent and the governing standards need to be clarified by this Court.

Proposition 4. Allowing a non-opt-out class representative to bind class members in an action at law for damages is inconsistent with *Brown* v. *Ticor Title Ins. Co.*, 982 F.2d 386 (9th Cir. 1992), *cert. dismissed as improvidently granted*, 128 L.Ed.2d 33 (1994). The question remains certworthy.

Proposition 5. The decision below gives effect to a release of the (federal) *disclosure* action given by a class representative who was appointed with respect to the very different (state) *fiduciary duty* action. This is contrary to the leading case, *National Super Spuds, Inc.* v. *New York Mercantile Exchange*, 660 F.2d 9 (2d Cir. 1980), already cited *supra*, in which Judge Friendly held that a class representative's agency powers are measured by the class complaint, and that "[h]aving received authority to represent class members solely with respect to" the subject-matter of the complaint—in that case, certain contracts—such a representative "had no power to release any claims based on any other contracts." *Id.* at 18. He added a footnote that exactly fits the situation here:

> "We assume that a settlement could properly be framed so as to prevent class members from subsequently asserting claims relying on a legal theory different from that relied upon in the class action complaint but depending upon the very same set of facts. *This is not such a case.* The settlement before us [which the opinion rejected] would bar Richards [or, here, Grimes and Holbrook] and others similarly situated from asserting claims, distinct from those represented by the class action plaintiffs, which depend *not only upon a different legal theory but upon proof of further facts*, namely, the holding of unliqui-

> dated contracts after May 7, wrongful default on those contracts, and the damages caused by the default [or, here, the withholding of material information, *scienter,* sale of stock in reliance, and damages caused]."

Id. at 18 n.7 (emphasis added).

The court below could deal with this only by baldly asserting that the instant action depends on the "very same set of facts" as did the state action. App. 22a. That is egregiously incorrect. See Table 1, App. 122a.

(Incidentally, Judge Friendly's reference to "claims relying on a [different] legal theory but depending upon the very same set of facts" was not made in the context of legal theories over which the court was without jurisdiction.)

Propositions 6 and 7. As described *supra,* the Delaware court ignored a cluster of indicia of a sham settlement. We submit that in a proposed class settlement there can be no "informed and independent judgment" as to adequacy of representation if the judge does not "apprise[] himself of all facts necessary for an intelligent and objective opinion." *Protective Committee* v. *Anderson,* 390 U.S. 414, 424 (1968). We submit that, at least where, as here, there are circumstances that would place a reasonable person on inquiry, due process requires the court to develop an evidentiary record from which adequacy of representation can fairly be appraised, and to show that it has given that record due consideration, before purporting to cut off forever the rights of class members. Since most class actions are settled, guidance from this Court on this point is needed to flesh out the *substantive* principle of *Hansberry* v. *Lee,* 311 U.S. 32 (1940), by defining the *procedural* minimum that a court must undertake to satisfy itself that the class is adequately represented. (This is the point on which Grimes sought certiorari two years ago. Denial of course was not an adjudication and does not preclude seeking it now.)

The court below held that Grimes and Holbrook could not "relitigate [*sic*] the factual issues of . . . adequacy of representation, and fairness of the settlement." App. 20a, 10a. Holbrook, of course, has never "litigated" anything and hence does not seek to "relitigate" anything. Under black-letter law, he *cannot* be foreclosed from contending here that due process was not accorded in the settlement hearing. "[C]ollateral attacks [are] a necessary part of the class action scheme," and are "integral to the constitutionality of the class action procedure." *In Re Real Estate Title and Settlement Services Litigation*, 869 F.2d 760, 769 (3d Cir.), *cert. denied*, 493 U.S. 821 (1989); *Hansberry* v. *Lee*, 311 U.S. 32 (1940); see *Martin* v. *Wilks*, 490 U.S. 775 (1989). Nor has Grimes "litigated" the question he raises under this proposition, *which is not the merits of the question of fair representation but rather whether he was given a full and fair chance to litigate that issue.* If he was not, he cannot be foreclosed now. *Kremer, supra.*

IV. CONCLUSION

The class action device—meant to *help* plaintiffs, not to *hurt* them—has gone off the rails. In particular, the "Delaware settlement" is an embarrassment to the law that should be dealt with by this Court. Its key is the notion that a state court to which Congress has denied any power over federal securities law claims can nevertheless force upon the holder of such a claim an agent authorized to sell it. This Court should confirm that this is unacceptable under the Supremacy Clause.

The efforts of the opinion below to circumvent that question are equally unacceptable. It offends due process to block a federal claim by issue preclusion not on the basis of true litigation and adjudication of the issues but merely because the claim was generally examined in a state court hearing on the settlement of other claims. It offends due process to allow a non-opt-out class representative, certified with respect to claims based on one set of facts, to

release claims based on different facts. It offends due process to allow a non-opt-out equity class representative to release claims for money damages at law. The holding that Holbrook had "minimum contacts" with Delaware offends due process and is fraught with enormous mischief for future cases. Finally, it offends due process to deny petitioners a fair opportunity to show that they were not fairly and adequately represented in the state class action.

The petition for certiorari should be granted.

Respectfully submitted,

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